Vermont Legislative Joint Fiscal Office

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ISSUE BRIEF

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Vermont Capital Gains Receipts

Introduction and Summary

Capital gains taxes have represented at least 8% to 14% ($60 to $84 million) of State personal income tax receipts from calendar year (CY) 2010 through CY2016. This issue brief attempts to provide background on the composition and fluctuations of capital gains receipts in Vermont. It also briefly examines the factors behind lower FY2017 capital gains but higher receipts in FY2018.

The main findings are as follows:

- The majority of taxes on realized[1] capital gains are paid by a small portion of filers.
    - Over the past seven calendar years of complete data, roughly 1% of Vermont taxpayers (those with Federal Adjusted Gross Income of $300,000 and over) are responsible for approximately 70% or more of total taxable capital gains.[2]
    - Over the past five completed calendar years, the top 15 taxpayers accounted for between 10% and 16% of total taxable capital gains.[3]
- Capital gains in Vermont have been marked by considerable volatility since CY2010 (the period covered by this brief).
- Capital gains receipts in Vermont are largely driven by three factors: market conditions for assets such as stocks, bonds, and real estate; one-time sales of businesses or property; and changes in tax policy at the Federal level.
- Volatility in capital gains is a significant source of uncertainty in forecasting personal income tax revenue each year. Capital gains likely played a major role in personal income taxes undershooting and overshooting the consensus revenue forecast in FY2017 and FY2018 respectively.

Background

Data for capital gains, as well as other income tax components, are typically compiled on a *calendar year* basis (January to December). This also corresponds to a given *tax year.* However, state revenues are typically collected and compiled on a *fiscal year*

[1] Realized capital gains or losses are those gains that arise at the sale of an asset. An individual may have capital gains or losses but they do not affect their taxable income until an asset is sold; otherwise, they are profits on paper only, known as unrealized capital gains. A realized gain is one that affects one's taxable income in a given year.
[2] Calendar years 2010 through 2016
[3] Tax returns processed as of June 1 of each tax year.

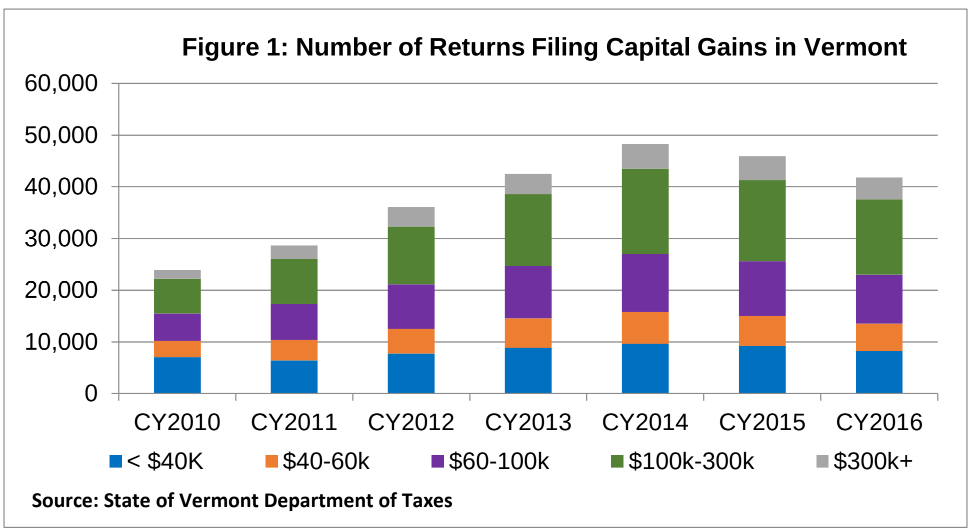
basis (July to June). Taxpayers file their tax returns for any given calendar (tax) year in April of the following calendar (tax) year. Therefore, the capital gains for any given calendar (tax) year would correspond to capital gains revenues in the following fiscal year.[4]

Vermont taxpayers are subject to personal income tax rates on the net gain from the sale of a capital asset less an exclusion. Gross realized capital gains are reported as part of Federal Adjusted Gross Income and Federal Taxable Income.

Vermont allows taxpayers to exclude a portion of their realized capital gains each year from taxation. Taxpayers can file for either a flat exclusion of $5,000 or a percentage exclusion equal to 40% of their adjusted net capital gain from the sale of assets held for more than three years. It should be noted that under the percentage exclusion, filers are not entitled to include the realized gains on the following assets: real estate, depreciable personal property, publicly traded stocks and bonds, and other publicly traded financial instruments. Therefore, the percentage exclusion is limited largely to sales of businesses or farms.

In CY2016 (FY2017), the most recent calendar year with complete data, 41,795 Vermont taxpayers filed income tax returns that included realized capital gains, with a median taxable gain of $3,170. Since CY2010, the number of returns with taxable gains has grown significantly.

The number of income tax returns that reported some realized capital gains increased markedly between 2010 and 2014, but has since declined. This is true across all income groups (Figure 5).

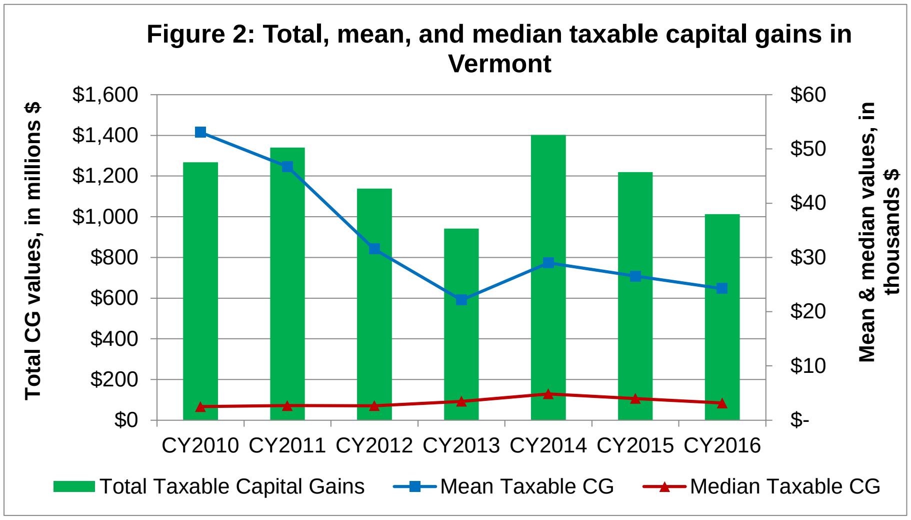


Note: Data for CY2010 and CY2011 include some data inconsistencies and may be less reliable than CYs 2012-2016.

[4] Some taxpayers may change estimated payments after realizing a major capital gain. Therefore, in some cases, capital gains for a calendar year may also create capital gains revenues in the same fiscal year.

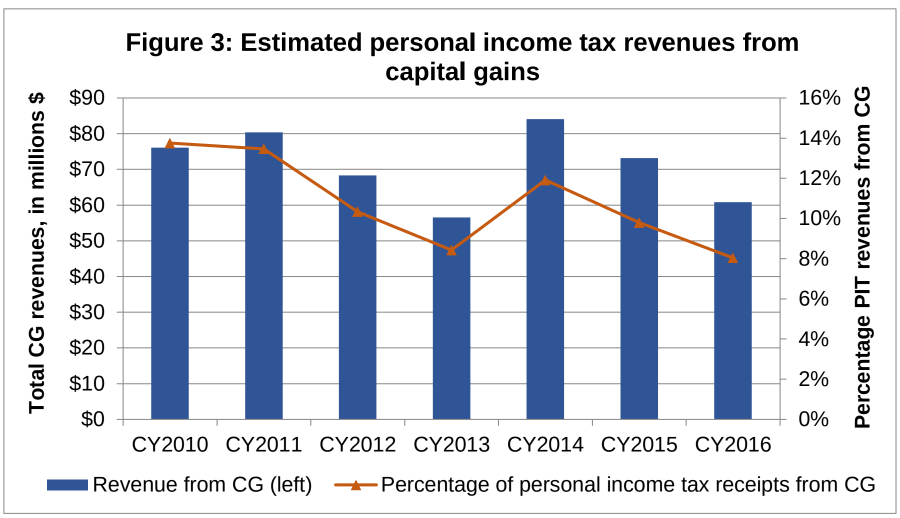
Over the past seven calendar years, capital gains reported by Vermont taxpayers have been volatile. The value of taxable capital gains fluctuate significantly from year-to-year, with swings of +/-15% or more not uncommon (Figure 2).

Average and median reported gains reflect this volatility as well. Capital gains are heavily concentrated among a small number of returns, as shown by the significant difference between the mean and median taxable capital gains in Figure 2.



Source: Vermont Department of Taxes

It is estimated that capital gains have accounted for between 8% and 14% of total personal income tax revenues between CY2010 and CY2016 ($60 to $84 million) (Figure 3).



The current Vermont capital gains exclusion was put into effect for calendar years 2011 onward.[5] The average exclusion spiked in 2012, but has since remained between $4,000 and $7,000.[6]

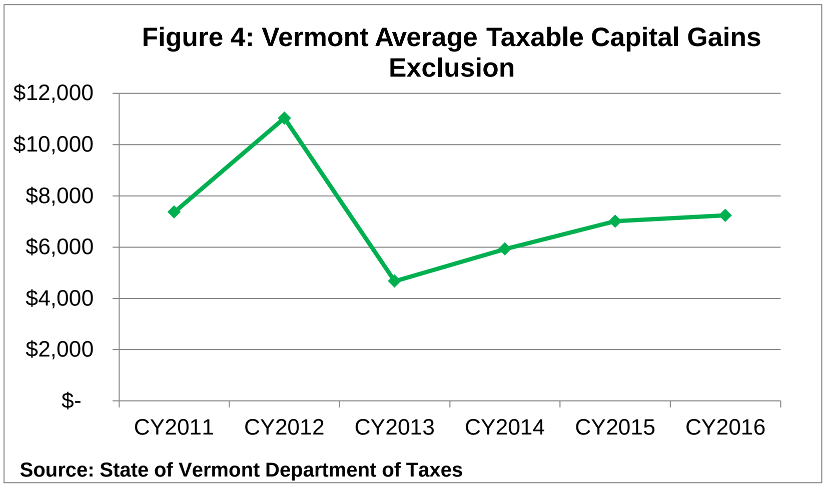


Figure 4: Vermont Average Taxable Capital Gains Exclusion

Source: State of Vermont Department of Taxes

* Data begin in 2011 because the current capital gains exclusion laws became effective for calendar year 2011.

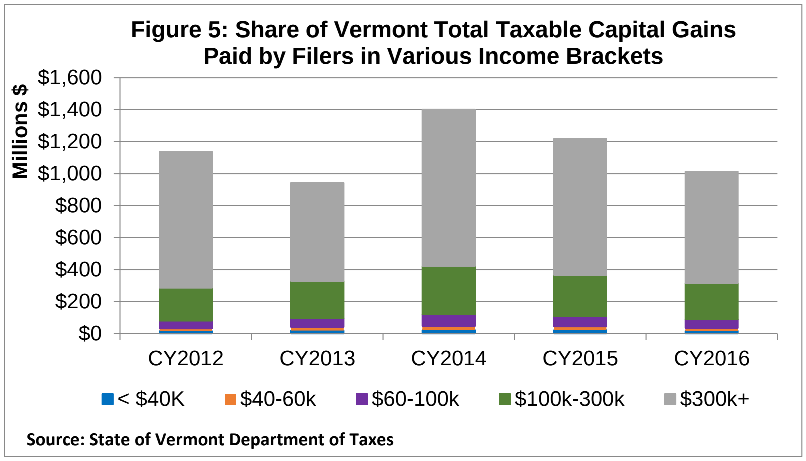
Higher-income filers, despite representing a relatively small number of returns, pay the majority of capital gains taxes (Figure 5).

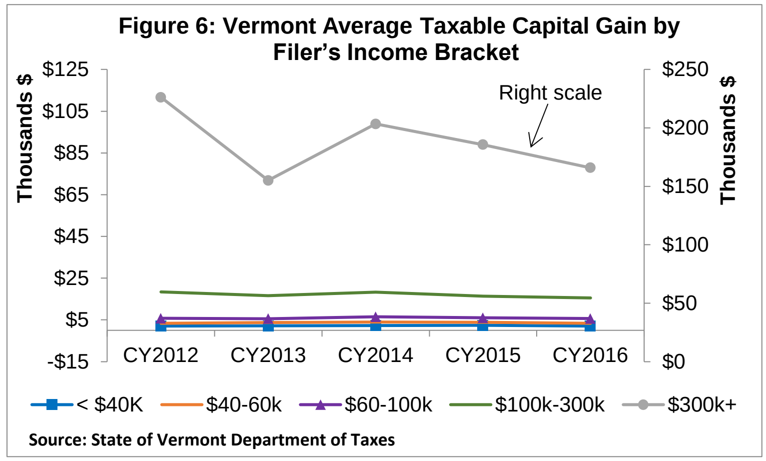
- In CY2016, returns with a federal adjusted gross income of $300,000 or more accounted for 70% of total taxable capital gains despite representing only 1% of total Vermont taxpayers (and 10% of Vermont returns with realized capital gains).
- Their average taxable capital gain of about $165,800 was nearly 10 times the average taxable capital gain of those earning between $100,000 and $300,000, roughly $15,700 (Figure 6).
- Since CY2010, the top 15 taxpayers for capital gains have accounted for between 10% and 16% of total taxable capital gains.[7]
- Over the past five calendar years, around 200 taxpayers have been responsible for nearly 50% of Vermont's taxable capital gains. Their average taxable capital gain was between $2 and $3 million per taxpayer. These 200 taxpayers need not be the same taxpayers each year.

[5] See State of Vermont Department of Taxes Legislative Updates, 2010. http://tax.vermont.gov/sites/tax/files/documents/2010%20Tax%20Legislation%20Highlights.pdf

[6] This average could be greater than $5000 because the percentage exclusion could exceed the $5000 flat exclusion. Taxpayers will choose the exclusion that allows them to exclude more of their capital gains.

[7] Using data through June 1 of each tax year.





Note: Data by income group from prior to CY2012 was excluded due to data inconsistencies.

Lower-income individuals and households with AGI below $40,000 have approximately 19% of all returns reporting some capital gains. However, their average taxable capital gain is significantly lower, or about $2,250 since 2010. The capital gains for this group could be coming from retirees with investment accounts (that earn capital gains), or high net-worth business owners who have substantial investments but experienced losses in any given year.

What drives capital gains receipts in Vermont?

Capital gains receipts in Vermont are primarily driven by three factors: asset market conditions, one-time sales of businesses or assets, and tax policy changes.

Asset market conditions

Realized capital gains result from the sale of a capital asset. These assets include but are not limited to stocks, bonds, and real estate. Even though an asset's value may go up or down, the state only receives revenues once the asset is sold.

Asset market conditions will drive state capital gains receipts in numerous ways:

- Asset prices: When the value of assets increases over a given time period, it creates a capital gain tax liability if the asset is sold. It is important to note, however, that asset classes do not necessarily increase or decrease in value at the same time. For instance, the stock market may increase in value at the same time the bond market is doing poorly.
- The types of assets people hold: Investors could increasingly choose to hold longer-term, less liquid assets like real estate. The decision to hold these assets long-term instead of selling would lead to a drop in realizations and lower revenues.
- Market expectations: People may choose not to sell their assets because of market expectations. For instance, an investor might choose not to sell his or her stock holdings this year in the hopes of rising stock prices in the future.

- Demand for money/financial need: As people look for new investment opportunities, they may sell some assets to free up money, generating capital gains revenues for the State.

One-time sales of businesses or other assets

Substantial volatility in capital gains receipts is partly driven by one-time realizations of capital gains. For example, the selling of a business is a one-time event that would yield a large capital gain windfall in a single year but not in subsequent years.

This is particularly true in a small state like Vermont with a relatively small number of high-income filers. As indicated above, capital gains are heavily concentrated among a very few high-income taxpayers.

These high-income taxpayers with large capital gains need not be the same group year after year. JFO's most recent tax study found that high-income individuals in Vermont are often not the same year-to-year, because high income among this group is frequently a one-time event. Capital gains are one explanation for these events.

The sale or merging of businesses also could create large, involuntary capital gains for taxpayers. For example, a taxpayer could passively hold shares (such as through a mutual fund) in a business that merges or is sold to another business. The sale creates a large capital gain for the taxpayer who would then owe capital gains taxes on their shares even though they did not actively choose to sell.

Tax policy changes

One explanation for volatility in capital gains is anticipated tax policy changes at the federal level. Taxpayers can choose to defer or not realize their gains until subsequent calendar years to take advantage of potentially lower rates or other policy changes.

Academic research has pointed to a fairly strong relationship between realized capital gains and tax policy changes. These studies have generally attempted to measure the percent change in realized capital gains in response to a 1 percent change in marginal tax rates.[8] One recent study found that this impact was -0.61; that is, for every 1 percent increase in marginal tax rates, the amount of capital gains realizations fell by 0.61 percent (Bakija and Gentry, 2014). Another study found an estimate of -0.79 (Dowd, McClelland and Muthitacharoen, 2012).

Tax planning is particularly prevalent among high-income individuals.[9] Realized capital gains deferrals in the hopes of lower tax rates in subsequent years would be strongest in this group.

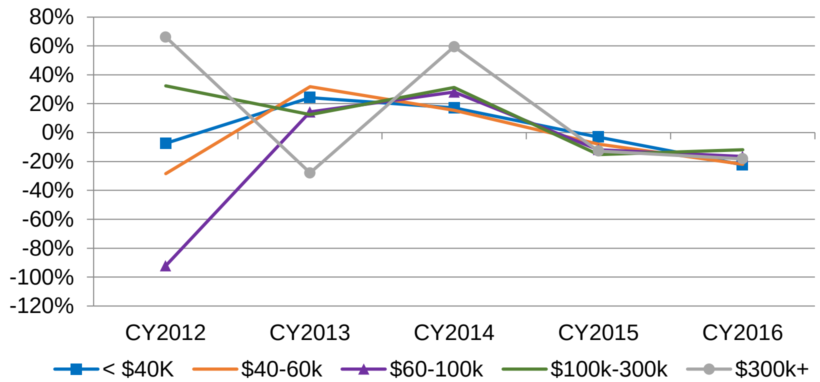
[8] If the current tax rate on capital gains is 15 percent, a 1 percent increase would mean the new tax rate is 15.15 percent.

[9] With higher tax rates on larger incomes, high-income individuals would logically have the incentive to attempt to lower their tax burden. See Dowd, McClelland, and Muthitacharoen (2012).There is also evidence of more tax planning by higher-income individuals with regard to estate planning. See Kopczuk (2007).

The volatility in Vermont taxable capital gains among the highest income group in the past does coincide with major recent pieces of tax legislation.

- Beginning in CY2013, the American Taxpayer Relief Act raised income taxes for this group. As Figure 2 shows, there was a decline in taxable capital gains in CY2013 relative to CY2012. Taxpayers, anticipating the higher rates in CY2013, likely decided to realize gains in CY2012.
- President Trump was elected in November 2016 on a platform of lower income tax rates. It is possible that in anticipation of future lower rates for CY2017, taxpayers responded by choosing to not realize their capital gains in CY2016[10] (Figure 7).

Figure 7: Vermont year-over-year percentage change in taxable capital gains



Source: State of Vermont Department of Taxes

Capital Gains Impacts on FY17 and FY18 revenues

Over the past two fiscal years, capital gains can help explain why personal income tax revenues have under or over performed relative to the State's official forecast.

Fiscal Year 2017

Despite increasing 1.3% over the previous year, FY2017 (07/2016-06/2017) personal income tax (PIT) receipts missed the forecasted target by approximately $13.8 million. Lagging PIT receipts was certainly not unique to Vermont; in the fourth quarter of CY 2016, [18 states had *declines* in PIT collections.][11]

Vermont taxable capital gains in FY2017 were down approximately 17% from the year prior and were $194 million below the historical average for the past five years. As Figure 7 showed, this decline occurred for almost every income group. If taxable capital gains in FY2017 had been similar to FY2016, income tax receipts would have been approximately $12.4 million higher in FY2017.

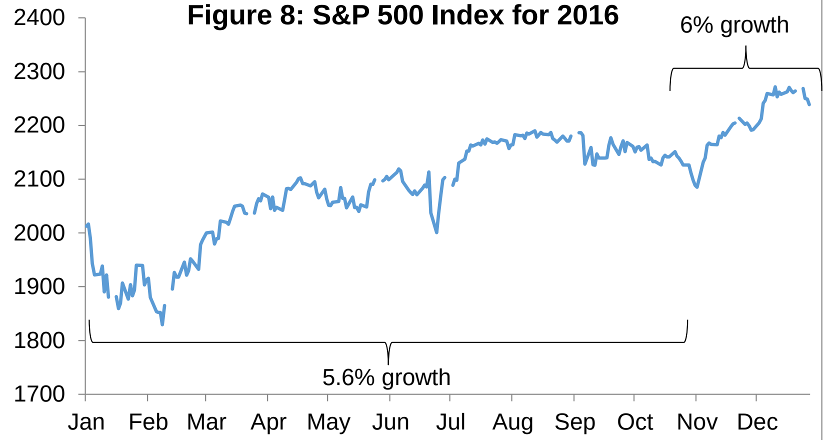
[10] The eventual Tax Cuts and Jobs Act was signed in late December 2017 and is effective for calendar years 2018 onward. Federal capital gains rates, however, were not changed in the final bill.
[11] State Revenues Report. Rockefeller Institute of Government. June 13, 2017. http://www.rockinst.org/pdf/government_finance/state_revenue_report/2017-06-13-srr_107.pdf

There are two possible explanations for this decline:

1) Anticipation of tax cuts in CY2017: Upon the election of President Trump in late 2016, taxpayers may have decided to not realize gains in CY2016, in the hopes that tax rates would be lower in CY2017. Because FY2017 revenues are dependent upon CY2016 capital gains, lower realizations would lead to lower FY2017 revenues.

2) Stock market performance: Annual returns of the S&P 500, a broad indicator of stock market performance, were 11% in CY2016, suggesting that CY2016 was an average year for the stock market. However, for the first 10 months, overall growth was just 5.6%. After the election of President Trump, anticipated corporate tax rate reductions spurred the market over the final two months (Figure 8). Investors could have decided to not realize gains in the hopes that the second-half run in 2016 would continue into 2017.

Figure 8: S&P 500 Index for 2016



Source: Federal Reserve Bank of St. Louis FRED Database

Fiscal Year 2018

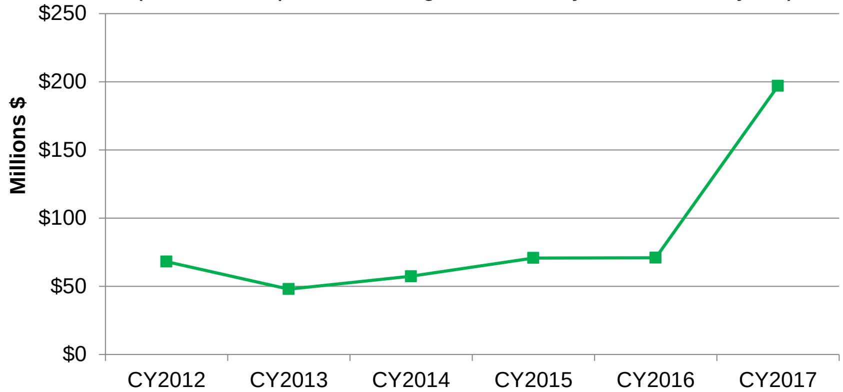
As of end-June 2018, personal income tax revenues for FY2018 were running $38.3 million above forecast. Preliminary analysis indicates that capital gains may be a major reason for this surplus revenue.

Based upon analysis by the Department of Taxes, data posted for tax returns through June 1[12] indicate that revenues from capital gains in CY2017 were over $15 million higher than the previous year at the same point in time.

The jump in capital gains is particularly notable for the highest income groups. Among those taxpayers with capital gains, the top 15 capital gains earners saw a substantial increase in their capital gains in CY2017 (Figure 9). The jump in this group of taxpayers helps explain a major part of the overall increase in capital gains.

[12] Over the past 5 years, 42% of total taxable capital gains data posted as of June 1 of each year.

Figure 9: Taxable Capital Gains for the Top 15 Filers
(For returns posted through June 1 of year calendar year)



Source: State of Vermont Department of Taxes

The exact cause of this jump is unclear, but the Tax Cuts and Jobs Act of 2017 likely played a direct and indirect role:

- Directly, it is possible that taxpayers who were waiting for lower tax rates on capital gains for CY2017 decided to realize their 2016 and 2017 gains once they learned that lower capital gains taxes were not going to be a part of the final tax bill.
- Indirectly, lower anticipated corporate tax rates played a major role in driving up stock prices.

Going forward, it is expected that the Tax Cuts and Jobs Act will continue to have an impact on capital gains:

- Repatriation of foreign profits could be used to increase corporate stock buybacks, leading to large potential capital gains.
- Increased corporate profitability could continue to drive stock prices higher in CY2018.

Other factors that may continue to drive strong capital gains in the future include:

- Investors could realize gains made since the trough of the Great Recession.
- Looser anti-trust regulatory policy, as well as strong corporate cash positions, increases the likelihood of mergers and acquisitions, leading to greater capital gains.

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